

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Senate Rev & Tax Com Analyst: Kristina E. North Bill Number: SB 1064  
Related Bills: See Legislative History Telephone: 845-6978 Introduced Date: February 27, 2003  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Exempt Organizations/"Corporation" Includes Limited Liability Companies

### SUMMARY

This bill would allow exemption from taxation for specified limited liability companies (LLCs).

### PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to exempt from taxation certain title-holding entities, thus reducing paperwork required from these entities and allowing these entities the flexibility to choose the most beneficial form of organization.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Current federal and state tax law allows exemption from the income and franchise tax for certain organizations. These organizations include the following for-profit business entities:

- ◆ single-shareholder corporations organized for the exclusive purpose of holding title to property, collecting income from the property, and transmitting the entire amount of income, less expenses, to another exempt organization; and
- ◆ corporations or trusts that:
  - 1) have no more than 35 shareholders or beneficiaries,
  - 2) have only one class of stock or beneficial interest, and
  - 3) are organized for the exclusive purpose of
    - (a) holding title to property and collecting income from it, and
    - (b) remitting the entire amount, less expenses, to one or more organizations exempt from taxation, which are shareholders of the corporation or trust.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director  
Gerald H. Goldberg

Date  
04/14/03

Current state law authorizes the creation of a business entity known as an LLC. An LLC consists of one or more members that may be individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, other LLCs, or other business entities. The members of an LLC are afforded limited liability similar to shareholders of a corporation but have pass-through taxes comparable to a partnership.

Under federal and state tax law, an LLC may elect to be treated as a corporation or a partnership. An LLC with a single member may be treated as a corporation or disregarded for income tax purposes. When an entity is "disregarded," its activities are deemed to be the activities of the owner (e.g., a sole proprietorship or a division of a parent company). Under Personal Income Tax Law (PITL), a tax and fee is imposed on every LLC not classified as a corporation that is organized, registered, or doing business in this state.

Under **federal tax law**, as stated in Announcement 99-102, 1999-43 I.R.B. 545, the Internal Revenue Service (IRS) treats a disregarded single-member LLC as part of its exempt owner for the purposes of exemption from federal tax on corporations. A separate application for exemption is not required.

California Legislative Counsel has issued an opinion concluding that a non-profit organization may not form and operate as an LLC.

### THIS BILL

This bill would exempt from taxation an LLC that is a title-holding corporation under specified Internal Revenue Code sections, whether the LLC is classified as an association taxable as corporation, a partnership, or a disregarded entity. Thus, a title-holding entity would have the flexibility to organize in the most advantageous form for its California activities.

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would occur during the department's normal annual update.

### TECHNICAL CONSIDERATION

As introduced, the bill allows exemption from taxes imposed under the Corporation Tax Law. The tax and fees imposed on an LLC not classified as a corporation is imposed under the PITL. Technical amendments are provided to accomplish the author's intent to allow exemption from the tax and fees imposed on an LLC not classified as a corporation.

### OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

*Massachusetts and Minnesota* do not impose a tax on LLCs at the organization level.

*Florida and Illinois* refer to federal law regarding exempt organizations.

*Michigan and New York* impose a tax on LLCs at the organization and do not provide an exemption comparable to the exemption allowed by this bill. No laws were found where these states provide exemptions from tax for LLCs used as title-holding companies.

## **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Revenue Estimate

This bill would have no identifiable revenue impact.

### Revenue Discussion

Neither the number of LLCs that are title-holding companies for tax-exempt parent organizations nor amounts of net income that would be otherwise taxable, if any, is known. Department staff believes that the tax-exempt organization community is well aware that an LLC for title-holding purposes is not currently exempt under California law. If this bill is enacted, department staff estimates the number of LLCs that could potentially qualify under this bill as very limited. To the extent there would be revenue losses in any given year, it would be "revenue by mistake." Revenue by mistake would result from an organization making a filing error, which could be corrected.

## **LEGISLATIVE STAFF CONTACT**

Kristina E. North  
Franchise Tax Board  
845-6978  
[Kristina.North@ftb.ca.gov](mailto:Kristina.North@ftb.ca.gov)

Brian Putler  
Franchise Tax Board  
845-6333  
[Brian.Putler@ftb.ca.gov](mailto:Brian.Putler@ftb.ca.gov)

Analyst	Kristina E. North
Telephone #	845-6978
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1064  
As Introduced February 27, 2003

AMENDMENT 1

On page 1, strikeout lines 1 through 9 and page 2, strikeout lines 1 through 10 and insert:

SECTION 1. Section 17941 of the Revenue and Taxation Code is amended to read:

17941. (a) For each taxable year beginning on or after January 1, 1997, every limited liability company doing business in this state (as defined in Section 23101) shall pay annually to this state a tax for the privilege of doing business in this state in an amount equal to the applicable amount specified in paragraph (1) of subdivision (d) of Section 23153 for the taxable year.

(b) (1) In addition to any limited liability company which is doing business in this state and is therefore subject to the tax imposed by subdivision (a), for each taxable year beginning on or after January 1, 1997, a limited liability company shall pay annually the tax prescribed in subdivision (a) if articles of organization have been accepted, or a certificate of registration has been issued, by the office of the Secretary of State. The tax shall be paid for each taxable year, or part thereof, until a certificate of cancellation of registration or of articles of organization is filed on behalf of the limited liability company with the office of the Secretary of State.

(2) If a taxpayer files a return with the Franchise Tax Board that is designated as its final return, the Franchise Tax Board shall notify the taxpayer that the annual tax shall continue to be due annually until a certificate of cancellation is filed with the Secretary of State pursuant to Section 17356 or 17455 of the Corporations Code.

(c) The tax assessed under this section shall be due and payable on or before the 15th day of the fourth month of the taxable year.

(d) For purposes of this section, "limited liability company" means any organization (other than a limited liability company exempt from the tax and fees imposed under this chapter pursuant to Section 23701h or Section 23701x) that is formed by one or more persons under the law of this state, any other country, or any other state, as a "limited liability company" and that is not taxable as a corporation for California tax purposes.

SEC. 2. Section 23701h of the Revenue and Taxation Code is amended to read:

23701h. (a) A corporation described in Section 501(c)(2) of the Internal Revenue Code, relating to certain title-holding companies.

(b)(1) Notwithstanding subparagraph (B) of paragraph (2) of subdivision (b) of Section 23038, for purposes of applying Section 501(c)(2) of the Internal Revenue Code under this section, the term "corporation" includes a limited liability company-classified as a partnership or as a disregarded entity.

(2) A limited liability company granted exemption under the authority of this section is exempt from the tax and fees imposed under Chapter 10.6 of Part 10 (commencing with Section 17941).

SEC. 3. Section 23701x of the Revenue and Taxation Code is amended to read:

23701x. (a) A corporation or trust described in Section 501(c)(25) of the Internal Revenue Code, relating to certain title-holding companies.

(b)(1) Notwithstanding subparagraph (B) of paragraph (2) of subdivision (b) of Section 23038, for purposes of applying Section 501(c)(25) of the Internal Revenue Code under this

section, the term "corporation" includes a limited liability company classified as a partnership or as a disregarded entity.

(2) A limited liability company granted exemption under this section is exempt from the tax and fees imposed under Chapter 10.6 of Part 10 (commencing with Section 17941).

SEC. 4. This act provides for a tax levy within the meaning of